Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

A Summary of Presentations at the 1988 Trends Conference*

The theme of the 1988 Trends Conference was "The Challenge of Securities Firm Management Today." The day's conference featured various senior brokerage industry executives addressing the overall challenges and problems of management within the securities industry and the peculiar nature of management in this industry. Topics ranged from managing your business in down markets to using technology and capital to improve profitability.

The keynote address from Primerica covered, "Financial Services Synergy: Reality or Illusion?" In addition, highlights of the joint Securities Industry Association - Arthur Andersen & Co. study entitled, "Wall Street's Workforce - an Analysis of Productivity and Personnel," were presented.**

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* The full transcript of the 1988 Trends Conference is available for $50. An order form is attached.

** Those interested in receiving more information regarding the Workforce Study may complete and return the attached order form.

INTRODUCTION

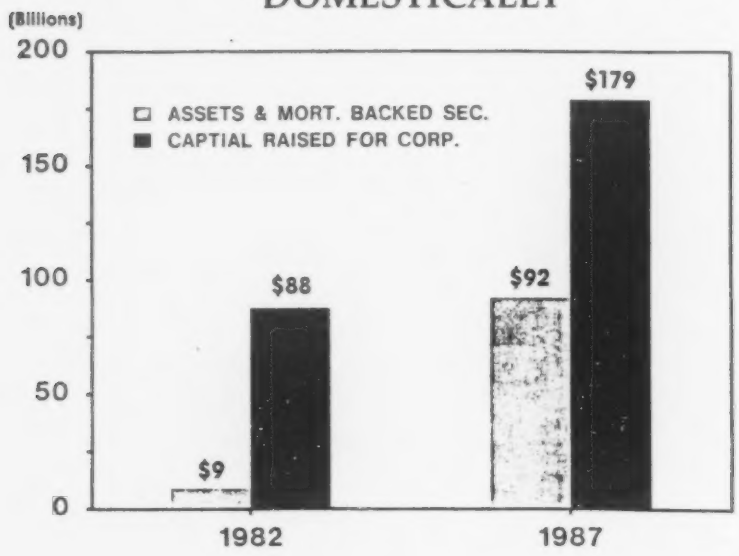
EDWARD I. O'BRIEN
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

While this has been a very trying year for the industry, the world should never be looked at in a vacuum. The past five years have been a time of tremendous growth and profitability for the securities industry. Many of the challenges we are facing today are a result of the rapid expansion of business which burst upon us from 1982 to 1987.

Despite the problems of 1987, the year still saw some major contributions from the securities industry.

TABLE 1

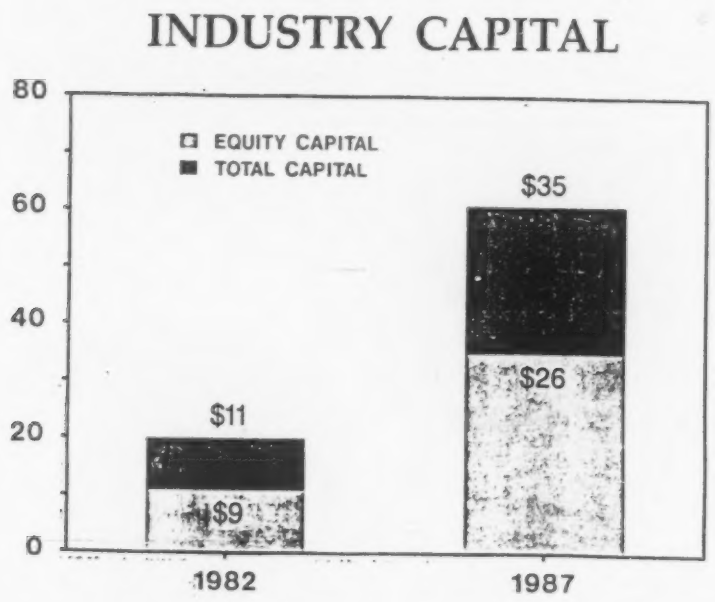
CAPITAL RAISED FOR CORPORATIONS DOMESTICALLY



As you can see (Table 1), capital raised for corporations through domestic underwritings in 1987 totaled $179 billion, double the level of $88 billion five years ago and second only to 1986's record of $218 billion. These underwritings exclude mortgage and asset-backed securities which totaled a record $92 billion last year, more than a ten-fold increase over the $9 billion raised just five years ago.

Over the past five years, industry capital has more than tripled rising from $11 billion at the end of 1982 to $35 billion last year (Table 2). Similarly, over the same period equity capital tripled, rising to $26 billion from $9 billion.

TABLE 2



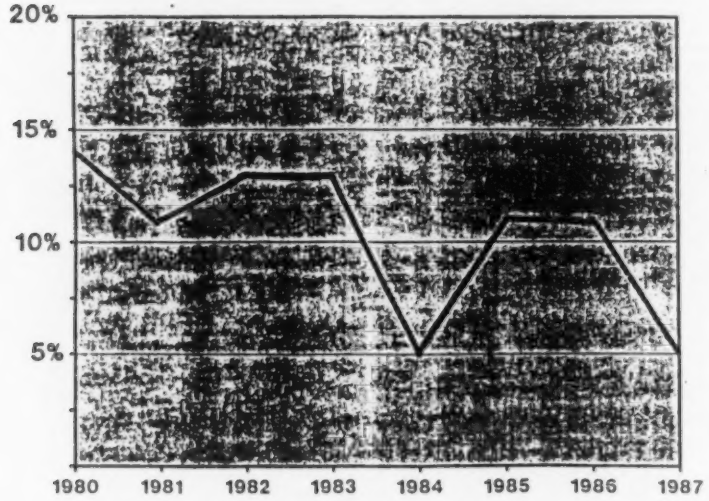
Losses sustained in the fourth quarter of 1987, projected to be around $800 million before taxes, dragged down the annual showing. At the end of the third quarter, the industry had an 18.6% pre-tax return on equity. The fourth quarter loss was the first quarterly loss by the industry in three and one-half years. The industry last posted a pre-tax loss in the second quarter of 1984, although the $100 million loss then pales next to the projected $800 million loss.

What is more alarming, however, is even in the good years of 1985 and 1986, return on equity hovered below 30% compared to 50% in 1980.

We see a similar deterioration in profit margins (Table 3). In 1980, 1982 and 1983, pre-tax margins were in the 13% to 14% range. In 1984, this fell to 5% and only returned to 11% during 1985 and 1986. Last year's poor showing fell back to around 5%.

TABLE 3

PRE-TAX PROFIT MARGINS



One of the areas where firms are making adjustments is in employment. This is a situation of concern to all of us. There are numerous job losses affecting our industry. This type of contraction is a painful process; certainly for the individuals affected, but also for those, probably some of you in this audience, who have to make and then implement these decisions. These are, after all, not just statistics or news stories, but friends, colleagues and co-workers. Lay-offs affect many lives.

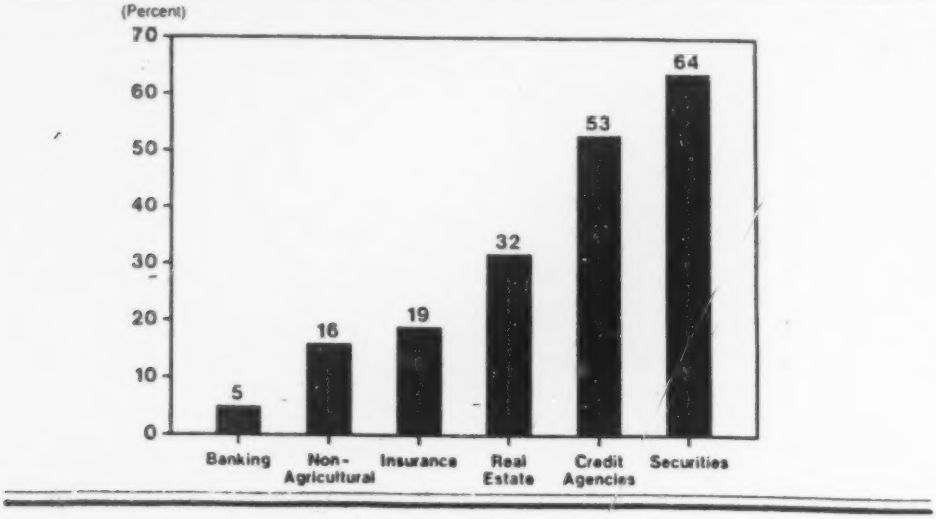
It might be helpful to put things in perspective.

This industry and all businesses have gone through other periods of contraction and have always bounced back. Employment in the industry has grown dramatically over the past five years. Employers of just SIA member firms have added 100,000 jobs since 1982, a 50% increase from 200,000 in 1982 to about 300,000 last year.

Statistics from the U.S. Department of Labor show an even higher growth rate for total securities industry personnel: 64% or over 160,000 new jobs created in the industry since 1982. In comparison, bank employment in the same five-year period had a 5% growth rate, while the insurance industry grew at 19% and real estate at 32% (Table 4).

TABLE 4

Growth in the Financial Services Sector Employment, 9/82 - 9/87



It is likely that some of the staffings in this industry were carried out too aggressively and now that the bull market has ended, abated, or at least taken a major correction, firms are adjusting to more modest staffing levels. At any rate, these moves have been swift, if not brutal, but they may now place securities firms in a better position for the periods ahead by lowering expenses.

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

JOHN S. CHALSTY
PRESIDENT
DONALDSON, LUFKIN & JENRETTE SECURITIES CORP.

When I joined DLJ in late 1969, I was appalled by what I perceived to be a lack of attention to the management process in the securities industry. I told people that the securities industry as far as I could tell was not a business at all, but in fact, a sort of cottage industry with various fiefdoms going their own separate ways. It was only later that I came to realize, with considerably more humility, that I was comparing a structured formal management process that I had become familiar with at Exxon, with an operating style that had served this industry very well for the decades after the war, the classic

partnership that is still practiced in many law firms and many other financial services firms.

In corporate America, management is an honorable and desired profession. The young would-be executive aspires to and starts training to be a manager on day one. Management is his or her goal, and a very honorable one too. The best manager gets the most out of the organization and eventually gets to be the boss. There's nothing wrong with that. In fact, that's the way the system should work. And that's because in most of industrial America, no individual by himself or no small group by itself can dramatically impact the fortunes of the company, for good or bad.

It's also inconceivable in most industrial American corporations for any employee to earn more than the person that he or she normally reports to. Now, compare that with the classic securities partnership of the 50s and 60s. Compensation was related to personal performance. The best performers, whether they be traders or salesmen, became leaders. But they became leaders in the sense of player managers, not in the sense of the classic managers of corporate America.

In addition, through most of those 50s and 60s, there were a couple of distinguishing things about our business which I think made that form of management quite appropriate. First of all, it was essentially an agency business. Capital was generally not at risk. The individual could contribute significantly by his own efforts to the good fortunes of the firm without exposing the firm to major risk. One was unlikely to produce a financial disaster.

The 70s changed that a lot, mostly because of shrinking margins. The ability for firms to make money was greatly impaired by declining commissions and shrinking margins in the 70s. A contraction resulted in our industry as mergers and acquisitions took place. The management of a merged company was different from the management of one's own partnership. The need to seek out new products and new businesses appeared to be substantial, and frankly, for most of the 70s, Wall Street did not have the capabilities, nor did it aspire to have the capabilities, to manage in the environment of the 70s as that evolved.

The 80s brought its' own set of changes. First of all, a very substantial increase in capital risk, often associated with new products but mostly an increase in the capital at risk, occurred and that's had some major results. It has resulted, for example, in the damage that can be done to the P&L, if not to the firm, by a single trader or group of traders.

Secondly, the big buzzword is internationalization in the 80s. And that's really a very difficult thing for most of us to do. We've tended to be parochial firms. The problems have totally overwhelmed most of the experience that any of us had

before. It's only been in the last few years that this has developed, and no one has really had experience in international events. Management hasn't yet understood the differences in culture and the differences in management style and the differences in control that are necessary in a European and Japanese environment.

New products have also been both an opportunity and a problem during these years. But most of all, the issue that has made this totally different than any experience any managers on Wall Street have had before is simply that of growth. This has become a totally different industry than it was 17 years ago or 18 years ago, or even just seven or eight years ago. We haven't built up a cadre of experience in the management of the very diversified, very different, very risky businesses that we are now involved in.

At DLJ, we emphasize three points in our planning approach: the process or determination of business strategy, capital commitment, and people. The result of a strategic planning process is not necessarily the important point -- the important point is the process itself. We spend a lot of time with a bottom-up approach involving the professionals in our various groups who come together and in the process of planning discover what they believe is the most likely set of circumstances for the firm in the year, and years ahead.

That very process helps in the understanding of those forces that act upon our business. Most important, it gives us all a sense of participation in the process, and a responsibility for the process, not only for its results but for the process itself. In fact, more for the process itself than for its results, because we recognize that the results are dependent upon exogenous factors that we certainly cannot control.

The final issue: every single chief executive on Wall Street speaks about the quality of his people. I get very annoyed when I hear our industry taken apart for greed or lack of ethics. I remind my friends in corporate America that there is no business that I know of anywhere, where individual standards of ethics and behavior are as high as in our industry. They have to be. If you think of the fact that every day transactions in the billions of dollars take place over the phone, between two people who have never met, and honor those transactions, were there just a tiny fraction of 1% of dishonesty in that process, the industry would stop working, stop functioning.

Finally, one issue that I'm concerned about and which I'm sure that everyone else who has a management responsibility on Wall Street is or should be concerned about, is that the management of growth gets particularly tough when the growth stops. And that may be where we are right now. I think that's going to be the real challenge over the next couple of years. Hopefully, the slowing in growth is only temporary, but that's the most difficult thing that faces us.

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

ROBERT F. SHAPIRO
PRESIDENT
RFS & ASSOCIATES, INC.

An important part of management's role, I believe, is the necessity for trying to read the tea leaves. Clearly at a point in time such as the one in which we are now, that is a very difficult challenge. Nevertheless, I don't think management can be responsible for, or be effective at, establishing policy and direction without some expectations for what the future will bring.

A firm must also have a mission. No organization can be all things to all people. Clearly, whatever activities a firm engages in, it must strive and believe it can be, among the best, where competition will not allow it to be less and still survive profitably.

There are two areas of activity which are fundamental to the very existence of this industry. Namely, the generation of investment ideas and the execution of these ideas via the relevant market. No firm can effectively service its clients without these abilities. During difficult economic times, firms must maintain their strength in this regard, even if it means incurring departmental losses for some period of time, albeit in manageable proportions. Clearly, therefore, firms must define their mission, constantly challenge the premises supporting it, and always be flexible and willing to change.

What, then, about the day to day? There are several categories of focus which I believe essential to any well-managed firm. Specifically, I shall comment on the following: personnel motivation and supervision, capital management, and the need for a culture.

What is essential in developing the environment that is necessary to properly motivate and develop a response amongst individuals in an organization is incentive plans and particularly those which ascend as productivity increases. This industry thrives on incentive, and I believe incentive formulas should always be utilized whenever possible.

Supervision. I think of supervision on two fronts: one being management's awareness of an individual's performance in meeting the profit goals established and the other having to do with compliance issues. I have always found in my experience that periodic reviews of business plans and their execution are essential. One positive result is that this constant reassessment by management naturally results in a continuing review of the qualitative performance of all personnel, thereby enabling management to alert those whose work was not satisfactory. Whenever possible, I think it is management's obligation and responsibility to alert its people with whom it is not satisfied, and most particularly why.

Events of the last several years have made it clear that no organization can have too effective a compliance regimen. It goes without saying that programs for monitoring and control are essential. But equally clearly, they are not the answers of and by themselves. An astute compliance department activity is essential to enabling management to do its job. But this is only the beginning. Departmental managers and senior management must be actively involved on a daily basis in perusing the regular reports devised and deemed necessary by it and the compliance group.

It is clear that any stable investment firm can only be so by virtue of an adequate capital base. Constant attention must always be paid to the various regulatory ratios so that a healthy leeway exists to be able to function flexibly. At the same time, this must blend with an appropriate return on investment and a strategy directed to accomplishing the same. On an everyday basis, it is a must that truly efficient and cost-effective financial controls exist.

Specifically, all trading activities should, in my view, have precise limits which should never be permitted to be exceeded without specific senior management approval. I also believe that certain aging criteria exist for all positions, and once a position becomes stale, it must be liquidated. In this regard, I think a short time frame is clearly healthiest and for me, anything beyond five trading days becomes a real exception, and with today's volatility, maybe this is too lenient. I cannot stress too strongly how important these issues are for any firm's fuel is both its capital base and how it is utilized.

The need for a culture. I have purposely reserved this area of comment for last, as I believe this to be paramount to any firm's long-term success. Effective management of a securities firm must communicate to its people an awareness of the important aspects and issues of every sector of the business; a basic sense of fairness and consistency in dealing with all personnel; a compassion for individuals and particularly when they have personal problems, and a high standard of values and ethical conduct. And the manner in which this materializes is a function of the effectiveness, and to some extent the frequency, with which an active dialogue transpires between individuals with management responsibility and those for whom they are responsible.

THE CHALLENGE OF SECURITIES FIRM MANAGEMENT TODAY

DONALD E. WESTON
CHAIRMAN
GRADISON & CO. INC.

I shall make ten key points that we believe are of paramount importance to the health and prosperity of a regional or local firm with diversified product and service capabilities.

1. Implement corporate mission -- offer the highest quality service, products and advice, with emphasis on those which are proprietary, while at the same time optimizing the shareholders' return on equity and operating within the spirit, as well as the letter, of the rules and regulations governing our business. Identify specific market or markets and concentrate firm resources: people, capital, proprietary products, and proprietary services.

2. Commit to a market vs. product driven philosophy. Maintain an ongoing market research to determine changing needs.

3. Differentiate yourself from your competition, such as with proprietary products and services, highest quality service and superior performance.

4. Develop a strong marketing plan to maintain and build market penetration.

5. Leverage small size/flexibility -- take advantage of size by moving quickly to fill niches created by changes.

6. Measure risk vs. potential reward while jealously guarding your capital base -- only commit capital where the potential reward is large enough to make a major difference in earnings.

7. Acquire or merge with others that bring desired capabilities or additional volume which would otherwise be more costly or impossible to build internally.

8. Create an environment to attract and retain key professionals by using: compensation tied to profitability at all levels of the organization; fringe benefit and retirement programs to encourage key management and producers to make a career with your firm; a computer operation/systems approach, and new offices with a positive environment.

9. Manage costs -- review each segment of business to determine profitability and eliminate those functions or products that are losers if they do not impact overall competitiveness. Over the past few years we have eliminated: corporate bond underwriting, naked option writing and an auto leasing operation.

10. Structure your organization and business in such a way that you are attractive to others in the event that this strategy becomes the best interest of the shareholders.

To summarize, I believe these ten key points are very important to continued growth, profitability and survival in the extremely competitive environment which lies ahead.

WALL STREET'S WORKFORCE
AN ANALYSIS OF PRODUCTIVITY AND PERSONNEL

MARC H. STERNFELD
PARTNER
ARTHUR ANDERSEN & CO.

Headcount contributes to two-thirds of a firm's non-interest expense. This includes not only salaries, bonuses, fringes, but also the space, light, heat, power and technology expense required to support today's Wall Street employee.

The costs of support, however, are often obfuscated with arbitrary distinctions, since when the support reports directly to the trading and sales desk, their salaries are a direct cost. Yet, when they work for operations, they often become part of the much-maligned allocated costs. Consequently, to accurately analyze the workforce, we created several working models of securities firms. Using our advisory board, we validated the job titles we had and sent out the survey to the SIA membership.

The response of the membership was excellent: 112 firms or 22% of those solicited responded. Moreover, 17 of the 20 largest firms responded, giving us a sample representing three-quarters of the workforce of the SIA membership or over 220,000 employees!

Of the total employees in the survey, 65% worked for the National Full Line firms (NFLs) and 16% for the Large Investment Banks (LIBs). If you include an estimate of those that did not respond to the survey, you conclude that two out of three of the industry's workforce work for one of the 20 LIBs or NFLs.

Looking at the workforce growth during the Eighties in terms of several factors, the industry has grown at the same pace. The workforce has grown about as much as offices and accounts in percentage terms. Meanwhile, the revenue growth in this period has outpaced the headcount growth by double, and profits have outpaced the workforce growth by 25%.

The stock market collapse of October and the acquisition of E.F. Hutton both have had an impact on the workforce. Although much has been written about the growing layoffs in the industry, in the last six months of the year the workforce has been reduced by less than 10% or less than the number of people that were added between January and June of 1987. So once again, 1987 will be a year where the industry's headcount will end larger than when it began.

What does the market collapse of October say about workforce levels? The crash is not as much a factor on the workforce as the impact the crash could have on the volume of business. The level of the workforce is related to the volume of activity and more importantly, the speed of the increase. If the impact of the crash flows through in terms of lower volumes, the number of people needed to handle that volume will be less.

Eight years of growth in headcount, revenues and profits have brought us to an industry of some 300,000 people. What do they do? Who works on Wall Street? In order to deal with the level of the workforce and with the issue of productivity, you have to deal with the majority of personnel. By focusing on the workforce, we focus on the dominating factor in the cost structure. But let's not forget that the workforce is also the dominating factor on the revenue side, and the contribution of individuals is obviously the other side of the analysis. Since so much focus is placed on understanding revenues, we're just trying to put balance into the analysis.

The most prevalent occupation on Wall Street is the retail salesperson. One out of four employees in the industry is a retail salesperson. What information can a firm provide to the broker to make him more productive, to help him sell more and different products to the customer base? The industry must increase its focus on marketing and applying techniques used by consumer product companies to better focus the sales effort, and to better differentiate between the productive and unproductive retail brokers.

Operations: those who clear and settle trades comprise almost 20% of the workforce. Traditionally, the industry has applied technology to make these people more productive. Yet, in many clients, we see that if you compare the cost, technology and labor of clearing and settling a trade over the past years, you will find that it has increased. As technology has made the individual operations person more productive, the mix of products has changed, where more and more of the industry's transactions are in products where automation has not fully taken hold.

The third most prevalent occupation is the retail sales support force. In this category lies 13% of the workforce. This category of support highlights different issues that firms must address. What is the function of these people? Are they making the retail salesperson more productive?

Our next category is secretaries and clerical, although this is primarily secretaries. One out of eight people in the workforce is in this category. Are secretaries managed by a professional in an organization, as is true in many other large institutions, or are you delegating this responsibility to the secretary's individual boss?

Finally, technology. Systems and communications represent six percent of the employees in the industry. When you add the equipment and service costs to the large personnel expense, the issues are: are you getting the most out of your technology dollar? Who controls that expense in your firm, and how can that expenditure be brought more into line to the business needs of the firm?

In summary, these top five occupations comprise 75% of the jobs in the industry, and if you're going to deal with the issue of productivity of the workforce, you have to deal with these five occupations.

Let's look at the ratio of support personnel to producer personnel. How many support personnel are needed to support the production force as one component of profitability? The ratio of support to producer workforce can be broken into three major component pieces: the ratio of support to producer workforce in the sales and trading business, the ratio of support to producer workforce in the fee-based business, and the ratio to firm support -- personnel, legal, finance, to the entire firm. The ratios of support to producer vary among the firms, from the highest level in the LIBs of more than 2-1/2 to 1, to the Regional/New York City-based regional firms with a ratio of 1-1/4 to 1. Given the high profitability of the LIBs, we see that a high ratio is not necessarily negative, but just one factor of understanding the firms in the industry's profitability. Interestingly enough, even in the small firms there are still more support personnel than there are producing personnel.

Among the general support categories -- personnel, finance, human resources, etc. -- we found that most of the categories among the firm groups are about the same, except for finance, that is internal finance -- accounting, control and reporting. Here we see that the relative number of finance professionals in the LIBs is much higher than in any other types of firms. We see that among the Regionals/New York City-based regionals, there is almost an inverse relation to the relative sizes of the finance staffs, showing that just being in the business probably requires a fixed level of finance function. However, the large sales and trading component in the Large Investment Banks and their worldwide presence have driven them to greatly expand their finance function.

Looking at the support to producer ratio, we bring together all support, whether it resides in the traditional support areas -- finance, operations and technology -- or directly in the producing areas. We found that one-third of the support personnel report to the producing departments. Therefore, whatever size you think your back office is, increase it by 50% to get the true cost of support for your firm.

FINANCIAL SERVICES SYNERGY: REALITY OR ILLUSION?

WALTER A. SCOTT
PRESIDENT
ASSOCIATED MADISON COMPANIES

Primerica entered the financial services industry out of carefully considered choice. Back in the late 70s and early 80s -- a period of extremely high inflation -- American Can, as we were then known, found itself in two primary industries: packaging and paper. Both of them were: capital intensive, growing slowly, and worst of all, experiencing severe margin pressure.

At that point, the corporation decided it would diversify into less capital intensive businesses with prospects of high profit margins and growth. One of the industries we identified was financial services. And indeed, in 1982 American Can definitely made the choice to enter that industry with the acquisition of Associated Madison.

We were attracted to financial services because it was an industry that had the characteristics we wanted: above average growth potential and opportunities for greater than average profits. One of our other major considerations was that financial services -- unlike many industries -- was not dominated by massive entities.

It is my opinion that in financial services, the key to success is distribution. If you find the companies that have better distribution systems or capability, and are low-cost providers of services, then it's easier to gain market share and see your profits grow faster than your competitors.

Since 1982, Primerica has acquired a significant number of services businesses. We had five insurance companies, then we entered the mutual fund and asset management fields, after that, mortgage banking, and, most recently, securities brokerage and investment banking.

In our evaluation of potential acquisitions we focus on the distribution capabilities, market niche, market growth potential and a company's competitive position.

We felt that by acquiring niche players in insurance and then in other complementary financial services, we could create value over and above what would exist if those companies operated totally separately by moving these complementary products through the insurance companies' distribution systems.

But do synergies actually take place? Are synergies real or illusory?

I think the answer is that synergies <u>can</u> be very real. But if a parent company tries to force them, they can quickly become illusory or unprofitable or both.

At Primerica, we have a group of highly entrepreneurial subsidiaries, affiliates and partners. We wouldn't have it any other way. They operate in tough, competitive businesses. In insurance, for example, our companies are sometimes competing against each other directly. They naturally want to do better in their respective markets than their sister companies do in theirs. So there is a healthy distrust among competitors.

The million dollar question is: how does the parent neutralize the resistance to synergies among subsidiaries? What is the parent's role?

The first thing is to realize is that to be successful the parent cannot dictate synergy. It would be like trying to force a bud to bloom. It doesn't work. The drive for subsidiaries to share resources -- in order to create value over and above what would exist if those operations worked separately -- has to in the final analysis come from the subsidiaries themselves, not the parent.

Our experience has taught us that the parent company can only help create the right environment for synergies. We can identify areas where joint ventures or other kinds of arrangements would be mutually advantageous for the subsidiaries, and then make it easier for top managers of the subsidiaries to acquaint each other with their respective businesses.

The process by which we've helped synergies is rather informal. We have roughly semi-annual meetings of the CEOs of our operations. The meetings present a good opportunity for the people to meet and mingle and get to know each others' businesses. It is particularly useful for the new companies to expose their businesses to the sector's CEOs. It is also very useful for the existing subsidiaries to get to know the heads of the newly-acquired businesses because it is on this level where things happen if they're going to happen.

So far, most of our synergies have been marketing synergies. There are also operational synergies developing and a significant financial synergy. I want to emphasize that we have no intention of evolving into a centralized financial services operation with a single back office and common management since we have a minimal sector staff. We do not look to merge back office operations, as long as the independent operating units can achieve an acceptable rate of profit growth and their operating results are equal to or greater than the competition.

Synergies certainly have a slower incubation period than we thought! And part of the reason is that the relationships are a little like the difference between people's relationships with friends and with family. It has been said that we let our

friends get away with a lot more than we'd ever let family members get away with. We say we choose our friends but we're stuck with our families! We get the hand we're dealt there. You tend to find more faults in your son-in-law than in your friends -- even if your friends have the same faults.

So I think the same psychology is at work in the process of synergies. But it does work itself out; reason does prevail in most cases. And subsidiaries do begin to appreciate the real virtues of their sister companies -- especially when it adds to their bottom line.

MANAGING YOUR BUSINESS IN DOWN MARKETS

BENJAMIN F. EDWARDS III
CHAIRMAN
A.G. EDWARDS & SONS, INC.

I guess the way to manage in a bear market is to have your act together in a bull market. By this I mean, you must know what business you're in, what market you serve, and what special niche or broad area as the case may be, you have targeted.

It was important for us at A.G. Edwards to know exactly what business we wanted to be in and how we wanted to pursue it. It was important for us to concentrate on it and on doing it well. We had to know what kind of firm we wanted to be and then unite to achieve that firm, that common purpose.

The goal of making a lot of money does not always unite people. In fact, it often sets them at each other's throats. So our goal should be to perform some function that serves the long-term interests of our market. We must be customer-oriented. The goal decided, it became a matter of how well we could perform together, how good a team we could be.

We ought to structure ourselves to achieve our purpose. For example, our compensation should be consistent with the corporate direction we've chosen. It's a crucial decision. In our case, it was teamwork vs. the star system. Everyone should have a self-interest in the bottom line. Everyone should be encouraged to put the customer first. Everyone should be encouraged to make decisions that will stand the test of time.

In our compensation system in the mid-60s, we had departmental overrides, we had a whole override system. We got rid of all overrides in the home office; those were not profit centers. Our profit centers were our branches, and the job of the people in the home office was to serve the ones in the field. It took about two years for people to believe us, but when they finally did, we wasted a lot less time and worked better because we could trust each other.

Adversity then, a bear market perhaps, becomes a common challenge which should draw us closer together rather than set us against each other. When things aren't going well, there is an almost irresistible urge to point fingers and blame someone other than ourselves. This must be fought.

The important thing is to rally together to work out solutions for the adversity. Cost-consciousness is a state of mind, an attitude of abhoring waste and furthering the common good. Some industry compensation practices would seem to do just the opposite. And I think here of examples -- one very sizable and notable firm recently spent millions and millions of dollars signing off with an executive. To me, that sends horrible signals to the rest of the organization.

I happen to be against paying bonuses for producers. I think that number one, you encourage people to make a move not for a career or professional reason; and two, you set yourself up for the person that comes along with a higher offer. You're vulnerable to that. And probably the most important reason is you give the signal to your own person that sits next to the one you've just gotten, you say, "you're a dummy. If you want 'X' thousands of dollars, you have to leave to get it."

Overrides -- I mentioned how debilitating they can be. An appeal to greed and not teamwork is something that is common in all the things I've just mentioned. Greed is a powerful motivator, but it can be a destructive one.

If structural or compensation changes must be made to meet the exigencies of a bear market, talk the alternatives over with those affected well in advance. Listen to their input and come up with an even-handed policy that can be at least understood, even if it is not liked.

As managers, we don't like to be surprised. Our people don't like to be either. Let's treat each other as we would want to be treated. Surviving a bear market or managing through one then becomes a matter of building a strong, open and trusting internal organization with the courage to adapt to changing conditions. Each of us should ask him or herself, "What am I doing that is making someone else's job more difficult? What can I do to help us be more effective, more efficient, or more productive? What can I do without -- not what can somebody else do without?"

My conclusion is that a healthy environment must be built within an organization, an environment encouraging teamwork and common purpose, and be in place if one is to manage successfully in a down market. All of your professionals will know what must be done. But your challenge is to get them to do it on their own.

USING TECHNOLOGY TO IMPROVE PROFITABILITY

LAWRENCE J. STUPSKI
PRESIDENT
CHARLES SCHWAB & CO., INC.

I was assigned the topic of "Using Technology to Improve Profitability" and I thought that considering the fact that industry expenditures in technology doubled in the last three years and are expected, in a pre-crash study, to triple by the end of the decade, I thought my topic was more a mutually exclusive contradiction, sort of an oxymoron.

Schwab is a company that is built around applied technology. It really is a data direct response marketing company and a data processing company. Everything that we do is built around our software and built around efficient processing. The "Wall Street Journal" last Friday articulated a number of the frustrations and the obstacles that we run up against using technology in the financial services business and we all have the deck stacked against us in this area: projects that come in 100% over budget, years late, 80% of your programming staff or your analytical staff working on maintenance, uneducated users, overeducated technicians, tremendous amount of frustration in the use of technology.

We have the deck stacked against us, and I think we have to try to move the odds perhaps a little bit in the other direction. And my antidote for moving the odds in the other direction is to stop wasting money

That's not a particularly insightful or brilliant statement, but I've picked three areas this afternoon to talk about that might be helpful.

The first one is to try to have a simple business objective or an over-arching philosophy toward any technology project that you attempt to implement. Believe me, the execution of the project will probably be very complicated. The chances are you will run into all of the frustrations that were outlined in the "Journal" article last Friday. It will be difficult; there will be delays. Things will fail, you will be late, you'll probably run over budget, you'll go crazy doing it -- so give yourself a little bit of an advantage and try to have a simple business idea, a simple philosophy that overrides the concept of your project, a clear business concept.

There's sort of a corollary to this rule which is, once you get the clear business objective, try to design the project and get it concluded while you still have the same brilliant conceptualizers and executioners working on it, because we all know that most of the idiotic things done in our companies were done by our predecessors. It's a constant rule. So if you wind up doing a project where you're going to have a number of series

of managements in there, it's kind of doomed to failure, because each group is going to come in and sort of negate what the group before it did.

The second thing that we've learned that I wanted to share with you is to try to knock off or meet a number of business objectives with technology projects. Being natural optimists, we always either underestimate the costs of these projects or overestimate the benefits. So what I like to try to do is stack the deck in my favor by trying to design projects that meet a number of business objectives.

Two quick examples. One is what we call our lead system, which we developed two years ago. This is a system that follows an ad from the time it's in our in-house advertising agency until the time it gets placed in the media. From this we can tell you what the cost is of a full-page on "Barron's" page six, and whether the mix of business that we get from that page is all equities or equities and options or big traders or small traders or whatever. It feeds a fantastically important system that is extremely efficient at monitoring and making constantly better our cost of acquiring new business. This system also basically runs our mailroom. Our whole outgoing mail operation is automated from this system, and it has a lot of modeling techniques. You can say, what if you did this to your price schedule, and overnight we could say what it does to the average ticket, what it does to the gross, which customers pay the most for it, which customers pay the least for it. This is a fantastic development all because we took the time to meet a number of business objectives by one technology project.

A bad example -- a missed opportunity, not a big screw-up -- was last year: a group from our branches identified a new customer ledger screen that would be used to respond to customer inquiries out in the field and they neglected to understand how the customer ledger screen was used in the back office for different functions. So when it came time to cut-over, what we wound up was two customer ledger screens instead of one, because the branch-oriented project didn't include the objectives of making the back office work simpler. Again, a missed opportunity. It probably wouldn't have taken much more than an extra week or two to include those specifications in the design.

Talking about wasting money and spending money, my third point is to try to pay attention to demand projections and manage your physical plant or your data processing plant or your expenditures accordingly. Although obviously you can't predict the market, I know exactly how much business we're going to do in 1988. We're going to do the amount of business that's dictated by the formula -- take the number of customers we have, add the number of customers we'll add this year, multiply it times the amount of money they have, times their inclination to trade in the market, times the convenience or accessibility that they can get to our firm.

Of course, people look at me and say, "that guy is a wise guy -- any dope knows that!" But the point is that the values in each one of those variables is not zero to infinity. The values that you can ascribe on those, in that formula, is something you can narrow down -- you can box the range. And once you begin to do that, clearly, the objective is to have enough capacity so that you can make some money and respond to customer demand in periods of high demand without going out of operational control and yet not carry so much expensive excess or idle capacity in times of slack demand, that you hurt yourself too badly financially.

The late British historian and author, Arthur Clarke, once said that "any sufficiently developed technology is indistinguishable from magic." Using technology in the securities business often seems like magic to us, but indeed, it is not magic. It is the hard-headed application of rules or principles like the three I talked about today, and a number of others, that will try to get us to the point where we perhaps stop wasting some of the money that we're wasting and get technology working toward the profitability of the firm.

USING CAPITAL TO IMPROVE PROFITABILITY

JAMES T. BARTON
PRESIDENT
PRUDENTIAL-BACHE SECURITIES INC.

It's my understanding that Jeff Schaefer picked the topics for this conference some time before October 19. Post-Crash, he may wish he'd renamed this discussion, "Finding Profits to Preserve Capital!"

Let's look at two periods during this decade. The first would include the years 1980-83. Purposely excluding the 1984 debacle, the second would include 1985, 1986 and the first three quarters of 1987. Of course, fourth quarter figures would undoubtedly bolster my argument.

During the 80-83 period, the securities industry as a whole enjoyed average after-tax ROEs ranging from 19% to 27%. However, beginning with 1985, the numbers were 16%, 15% and 10%. Thus, even before October 19, the post-84 boom did not come close to the pre-84 period in terms of equity returns.

One of the most interesting details to come out of this analysis is the deterioration in the profitability of large investment banks. From a peak ROE of 30%-plus in 1981, their average ROE had plunged by June of last year to less than 10%. The line graph for the segment looks more like a cascading waterfall than an Alpine landscape. What makes that so interesting is that many of us have looked to investment banking as a source of new and ever larger profits.

Of course, we could look at the high ROEs of the early 1980s as an historical aberration. In the late 70s, for example, the highest the industry average ever got was 17.6%. For the same period, large investment banks saw year average ROEs no higher than 22%; and, in fact, they fell as low as 8% in 1977-78.

What is more, as many firms have expanded in recent years they have rapidly built up their equity capital through retained earnings and investments -- so much so that earnings may not have grown as fast as capital has.

Yet that possible explanation only leads us back to the original question. That is, what kind of returns will invested capital command in the future? Could even higher profitability be in store? Or might we be throwing good money after bad on the basis of out-dated expectations?

With many of us already responsible to public shareholders or private parents, the pressure to generate higher ROEs has intensified. One way to attempt to do that is to leverage our balance sheets, which, of course, increases risk.

Second, we could bring costs, especially compensation, back to earthly levels -- and, for once, keep them there. From the looks of it, this now seems to be the most commonplace, if not the most universally popular, way to battle revenue stagnation. Draconian cost-cutting measures today, however, may undermine a firm's efforts to seize opportunities tomorrow.

A third option is to pursue a niche strategy. A lot of firms have decided to focus on a particular specialty, like merchant banking or asset management, rather than being all things to all people. The risk of this strategy is that this year's profit opportunity can become a loser next year.

Indeed, none of these approaches is <u>the</u> single answer. Any strategy must recognize that, in today's increasingly complex global marketplace, substantial capital will be required.

As firms searched for ways to wield a competitive edge, to preserve fees, to enhance profits, they've put their capital -- and reputation -- more and more at risk. The first stage was the bought deal -- to secure an underwriting the firm dedicated its capital to buying entire issues. The next stage came from the M&A department. To secure takeover and LBO business, firms issued "highly confident" letters and then provided capital directly. Now, they're providing bridge financing and taking equity interests in deals -- merchant banking.

Merchant banking is risk and with it comes potential enormous returns or losses. There is the risk that a junk bond will fail; a bridge loan will go unpaid; a company in which you have an equity interest will fail or be bought out at unfavorable terms. You may have to run a struggling company and

there are conflicts of interest, i.e. being an advisor, lender and owner all in one.

Finally, we must become more adept at balancing our short-term and long-term needs. We have to boost our current earnings to generate the capital we need, and at the same time we have to position ourselves for tomorrow's competitive environment so we will be able to secure and maintain a leadership position. Management skills in this balancing will sort the men from the boys.

CONCLUDING ADDRESS

JOHN W. BACHMANN
MANAGING PRINCIPAL
EDWARD D. JONES & CO.

I'd like to start by asking the question, what is management? There are so many possible answers. Management is people. Management is systems. But today, for my purposes, I'd like to think of management in two ways. I think management is discipline and management is performance. Before we can measure the performance of management, we have to know what business we're in and that starts with a definition of a mission. That describes your purpose. And the mission is never to make money because to make money does not inform, it does not tell us what decisions to make or not to make in the long run. It does not define a higher expectation or something that people can unite behind. So we know it's not money.

At Edward D. Jones, the mission is a very short one -- it's to serve our customer, the individual, with reliable financial products, in unequaled service from convenient locations throughout America. Now, we don't do that yet, but that's something that we aspire to. The second thing is a part of the discipline -- a vision. Where is the organization going? How will it look in the future?

The third thing you need is goals or objectives, and those have to be measured. Those have to inform you of your performance, so you know how you're doing. And of course behind all that are your strategies -- how are you going to get where you're going? What are your strategies on training? So then, once that's in place, we can begin to think in terms of measuring performance.

The most difficult task of the manager is systematically thinking about the future. Why is it so difficult? Management requires objectivity, systematic thought, great patience with people. It also requires the ability to say no. And even more difficult, the ability to abandon, and it requires that we have a long-term focus. In a word, discipline. And it's difficult in a transaction business where people are so used to dealing

instinctively, to be able to step away from that and take a long-term perspective.

At Jones, we have certain assumptions about the securities industry. It's clear that deregulation, which goes back to the early 1970s, has made a profound change on our business, a change that we feel today, because it has compressed margins. Deregulation attracted new, highly skilled and highly capitalized competitors. Companies such as American Express, General Electric, Sears, have found the industry very attractive. It's also shifting us from a relationship business to a transaction business. It's also forcing us away from a product focus toward a customer focus. It's also turned many of the traditional services into commodities. It's encouraging new product development. It's also increasing sharply the risks that we're forced to take, increasing the need for capital.

What are the responses to this kind of a competitive environment? It seems to me there are four. First, one can increase the velocity of current transactions -- in other words, do things more often, do them in larger quantities. One can also add components to the revenue stream, add new products, new services. We're seeing that. One can add value to the transaction or to the relationship -- certainly the computer is one way of transforming data into specifically tailored information as a way of doing that. And another way is to take greater risk, and we're certainly seeing that.

Now, looking at some of the tools of the manager, we've got to learn to be good marketers in our industry, because the new competitors that we are attracting to some extent are people who see the potential for marketing and believe that's what will give them their competitive advantage. I've come to believe that marketing is learning the wants and needs of the customer, so that you can deliver a product or service which the customer will recognize and embrace. Marketing is doing systematically what one does instinctively or haphazardly, and it is also simply organized common sense.

The second tool of the manager is technology. Technology is a way you're going to differentiate service, and the people that understand technology are going to have a big advantage if they can use it to deliver a product that makes, for example, the customer's monthly statement understandable.

The third tool is training. Along with technology, training is the other greatest productivity tool that's available. Training enables people to learn a system. It enables the organization to build expectations in people. It enables them to transmit the cultures, the values, the beliefs, and the legends that each of our organizations cherish.

The fourth is the organizational structure. Ben Edwards talked about how his organization is structured to focus on a

common effort. Oddly enough, our own organization with no help from them, and them with no help from us, came to a very similar conclusion. At Jones, we have gone to great effort to be able to remain a partnership. We try and embrace and underscore this concept of partnership; you don't have to be a partnership to do it but we are and we still cherish that.

I'd like to take a look at the fifth area, which is capital. The ultimate measure of performance is return on capital over the cycle -- from peak to peak or valley to valley. Return on capital is diminishing, however, as competition increases.

I'd like to say a word about profits, because I think that people at times forget what profit really is. Profit is not revenue minus expense. You might think so, but it's not. Profit is revenue minus expense minus the cost of capital, plus the risk differential.

The sixth area I'd like to take a quick look at is control, and control is the instrument by which we steer. We look at aggregate numbers and as an organization grows, the aggregate numbers are so big that they're awesome. But we need to remind ourselves that numbers are relationships. Relationships tell us what we need to know, i.e. - margins.

We also look at percentages, return on capital per unit would be an example -- we are very concerned with cost per investment representative. These are the kinds of numbers that we need if we deal with what is clearly one of the key issues facing investment management or securities industry management today, which is white collar productivity.

The times today are no tougher than they've ever been. Our business tends to be one that when times are good, we exaggerate how good they are, and when times aren't so good, we exaggerate how bad they are. But the fact is, they tend to balance. And we forget this fact, and I catch myself doing it, and say -- boy, wait till things get back to normal. This is normal. You know, the most abnormal period in the modern history of America was 1950 to 1970 -- 20 years of economic expansion and rising markets is probably the biggest aberration in the history of the Republic. So these kinds of markets and these kinds of times with turbulence and uncertainty are normal. If we accept it, it makes life a little more understandable. And so as long as we keep in mind that every uncertainty, every crisis, creates opportunity, I see a very, very bright future for the securities industry.

VOLUME

	DEC 1987	YTD 1987	DEC 1986	YTD 1986	% CHAN YTD 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	178.5	188.7	148.2	141.4	33.5%
AMEX (MILS.)*	13.4	13.9	12.3	11.8	17.2%
NASDAQ (MILS.)*	135.1	149.6	119.3	113.8	31.5%
REGIONAL EXCHANGE (MILS.)*	30.9	27.9	26.6	23.7	17.9%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$114,214	$1,873,598	$122,915	$1,374,350	36.3%
AMEX (MILS.)	2,784	51,137	3,373	41,752	22.5%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,665	132,756	11,527	108,517	22.3%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	17,155	208,782	27,150	220,640	-5.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	48.9%	51.2%	49.8%	50.0%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	8,998	182,114	12,780	180,358	1.0%
AMEX OPTIONS	2,916	52,771	3,011	49,074	7.5%
COMMODITY	16,656	228,772	13,169	184,337	24.1%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	FULL YEAR 1987	FULL YEAR 1986	% Change 1987-1986
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$271,477.1	$286,039.6	-5.1%
Common Stock	$41,054.5	$43,037.3	-4.6%
# of Common Stock Issues	842	1,199	-29.8%
Preferred Stock	$11,361.1	$13,982.8	-18.7%
# of Preferred Stock Issues	160	187	-14.4%
Corporate Debt	$219,061.6	$229,019.5	-4.3%
# of Corporate Debt Issues	2,305	2,391	-3.6%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$76,034.9	$114,094.7	-33.4%
# of Issues	3,151	3,770	-16.4%
Competitive	$23,661.0	$33,446.7	-29.3%
# of Issues	3,340	3,913	-14.6%

Source: IDD Information Services

PRICES
(END OF MONTH)

	DEC 1987	DEC 1986	% CHAN YTD 1987-1986
DOW JONES INDUSTRIALS	1938.83	1895.95	2.26%
STANDARD & POOR'S 500	247.08	242.17	2.03%
NYSE COMPOSITE	138.23	138.58	-0.25%
AMEX MARKET VALUE INDEX	260.35	263.27	-1.11%
VALUE LINE COMPOSITE	201.62	225.62	-10.64%
NASDAQ COMPOSITE	330.47	348.83	-5.26%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Report of the Presidential Task Force on Market Mechanisms	Detailed analysis by Brady Commission of the market break leading to the conclusion that: 1. from an an economic viewpoint, the markets for stock, stock index futures, and stock options are one and 2. given one market, there should be one agency with the authority to coordinate cross-marketplace issues. Unified clearing systems, consistent margin requirements, and "circuit breaker" mechanisms are among the Task Force's recommendations.	Commerce Clearing House 4025 W. Peterson Avenue Chicago, IL 60646 Report. no. 1267 Price: $6.00
The October 1987 Market Break	SEC staff finds the existence of futures on stock indexes and the use of various strategies involving program trading were a significant factor in accelerating and exacerbating the decline. Calls for curbs on speculation in stock index futures. Study recommends bolstering the financial strength of market-makers and encouraging greater disclosure of the identity of big buyers and sellers of stock.	Commerce Clearing House 4025 W. Peterson Avenue Chicago, IL 60646 Report no. 1271 Price: $9.00
Final Report on Stock Index Futures & Cash Market Activity During October 1987	Review of trading activities finds that the massive wave of selling that engulfed both stock and futures market was precipitated by an unprecedented change in investors' perceptions and not initiated by technical trading strategies which interacted with each other and the stock market. Urges better communications between exchanges.	Commodity Futures Trading Commission Office of Communication & Education (202) 254-8630
Financial Markets -- Preliminary Observations on the October 1987 Crash	GAO found two areas needing immediate attention to restore confidence in the markets. Given problems with automated systems during the crash, the GAO recommended that the SEC reassess its oversight role and capabilities for evaluating systems. Also recommended are intermarket contingency planning in order that self- and federal regulators can act in unison in dealing with any future market emergencies.	U.S. General Accounting Office P.O. Box 6015 Gaithersburg, MD 20877 5 copies free/ additional $2.00

Item	Description	Source
Banking Regulation in the Era of Financial Innovation	Dr. Klein explores the unique status of banks in the spectrum of private enterprises. Since banks are not like other businesses, they must operate under regulation designed to serve the economy and to allow efficient bank functioning. To improve the position of American banks, he recommends: 1. strengthening the deposit insurance system; 2. coordinating banking regulations and monetary policies with our global partners; and 3. maintaining regulations that steer banks into being good bankers rather than general financial institutions in the modern environment.	SIA Research Department (212)608-1500 $5 for non SIA members no charge for SIA members
"Gapital Gains"	Authors Gravelle and Lindsey consider the general economic issues surrounding the taxation of capital gains. They conclude that a cut in the capital gains tax on corporate stock would likely increase the efficiency of the tax system. Also, they note that the existing limits on capital losses create an asymmetric tax treatment that could be reduced by lowering the capital gains tax rate. Finally, they agree that a cut in the capital gains tax rate would produce higher realizations, but whether the extra revenue would offset the cost of the rate cut is an area of disagreement.	Tax Notes 1/25/88
Transcript of: International Capital Markets Opportunities & Challenges	Deregulation. Innovation. Liberalization. These three forces have created new opportunities for overseas investors, issuers and intermediaries. Speakers at SIA's October 1987 International Conference commented on these three factors and their influence on today's global markets.	SIA Research Department $25 attendees $100 others

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. XIV, No. 2 March 28, 1988

YOU CAN RUN BUT YOU CAN'T HIDE -- 1987'S KNOCKOUT PUNCH!

HIGHLIGHTS

1. The securities industry absorbed an unprecedented $2 1/4 billion pre-tax loss in 1987's final quarter. This was 22-fold the previous record loss of $100 million during 1984's second quarter and easily offset the $2 billion record quarterly profit booked in last year's first quarter.

2. The $2 1/4 billion pre-tax loss inflicted on the securities industry in 1987's final quarter is attributable to two P&L lines: a $1.3 billion loss in firms' investments and $720 million in error and bad debt costs.

3. For the year, the industry posted a mere $1.1 billion pre-tax profit. Not only was this an 80% free-fall from 1986's record $5.5 billion profit, it was, not even adjusting for inflation, the lowest level in nine years.

4. The securities industry's declining profit margin and return-on-equity were driven home by 1987's piledriving results. Last year's pre-tax profit margin and ROE of 2% and 4 1/2%, respectively, were 13-year lows.

5. During the fourth quarter, while the DJIA was losing one-third of its value in a week as all U.S. stocks lost $1 trillion in value, the securities industry's assets were slashed 20%, from about $500 billion to $400 billion.

6. Taking a longer-term view, the declining profitability in the securities industry is attributable to: volatile income sources coupled with runaway costs. Over the seven years ended in December, expenses skyrocketed 261%, easily outpacing a still-impressive 216% revenue rise.

7. Efforts in the last few years to reduce profit volatility have been fruitless. Since the industry has become more dependent on risk-taking activities, its profit picture has become more rather than less volatile. Securities firms have evolved from acting simply as customer agents, to taking principal positions in securities, and finally, to taking actual positions in companies.

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RETROSPECT

Disastrous -- the only way to describe the year just passed. Profits plummeted over 80%. The industry profit margin was the lowest in 13 years. Return on equity also fell to a 13-year low. The industry was hammered with a quarterly loss 22 times the magnitude of the previous record loss. Almost one-fifth of the industry's assets were wiped out in one quarter. Meanwhile, one-third of the Dow Jones Industrial Average was wiped out in just one week. The same week, $1 trillion was pared from the value of U.S. stocks. All global equity markets experienced panic selling. New negative records were set across the board, even dwarfing those set in the 1929 stock market crash. Disastrous!

A quote from the "Highlights" page of Trends one year ago this month: "In 1986, the securities industry earned a record pre-tax profit of $5.5 billion, up 33.1% over 1985's then record $4.1 billion." Now, update '88: in 1987, the securities industry earned just under $1.1 billion in pre-tax profits, down more than 80% from the previous year. Not even adjusting for inflation, 1987's profits were the lowest in nine years.

Following the October market collapse, the securities industry posted a record quarterly loss of $2 1/4 billion. That is 22-fold the previous record quarterly loss of $100 million experienced in the second quarter of 1984, which was also the last time the industry posted a quarterly loss.

The fourth quarter's loss also exceeded in magnitude the record quarterly gain. That gain, a pre-tax profit of $2 billion, also came in 1987 - during the first quarter. If nothing else, this certainly highlights the volatility of the securities industry, which is generally regarded as the most volatile industry with regards to profits in the United States.

This volatility is best emphasized visually as shown by aggregate pre-tax profits on a quarterly basis during the Eighties. Table 1 certainly highlights the volatility in profits (and losses) and note how the peaks and troughs, and the swings between them, are getting larger.

As volatile as the quarterly profits in Table 1 appear, when these quarterly profits are plotted against other parameters, revenues and equity, not only is the volatility again highlighted, but a disturbing trend begins to unfold.

Tables 2 and 3 demonstrate the quarterly volatility in industry profit margin and return on equity, respectively. Clearly, the trend is downward, despite the bull market in equities for most of the interval being measured.

Table 1

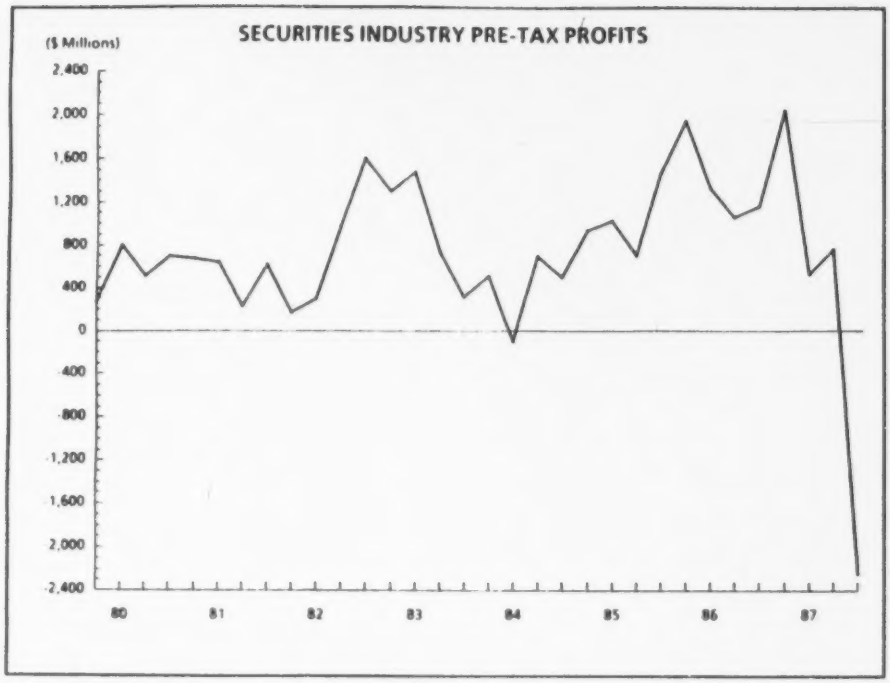


Table 2

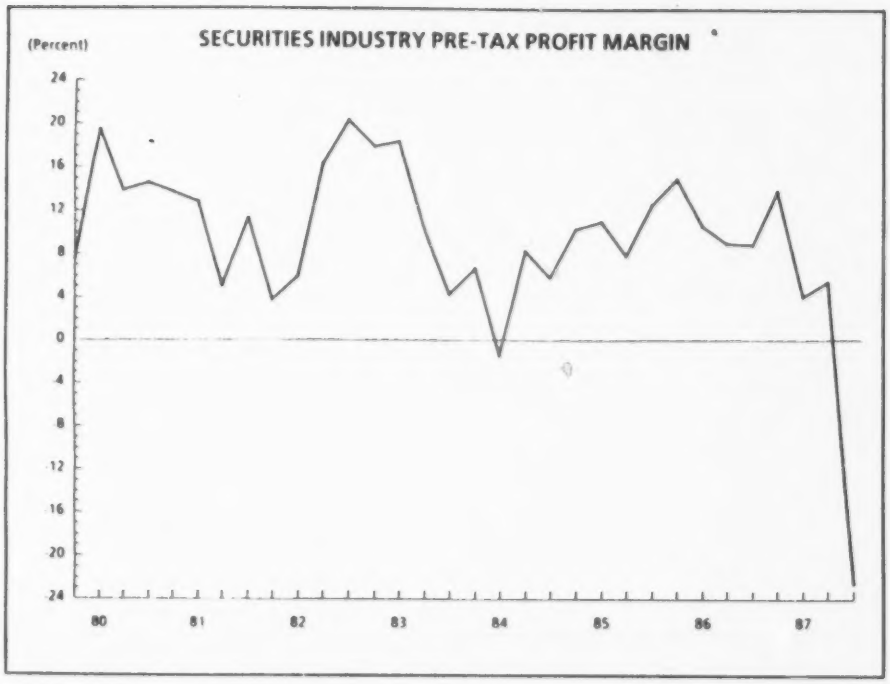


Table 3

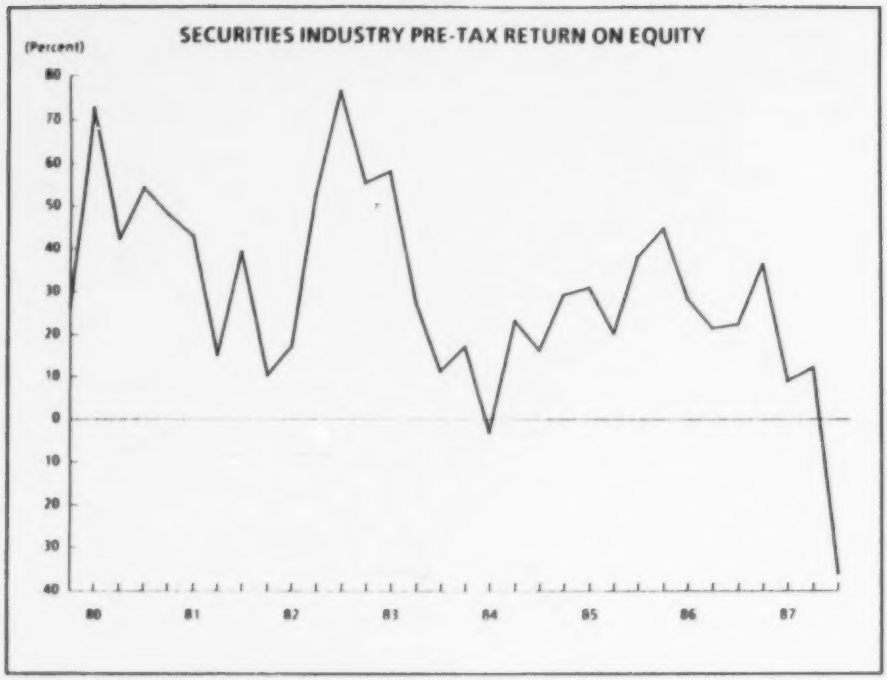
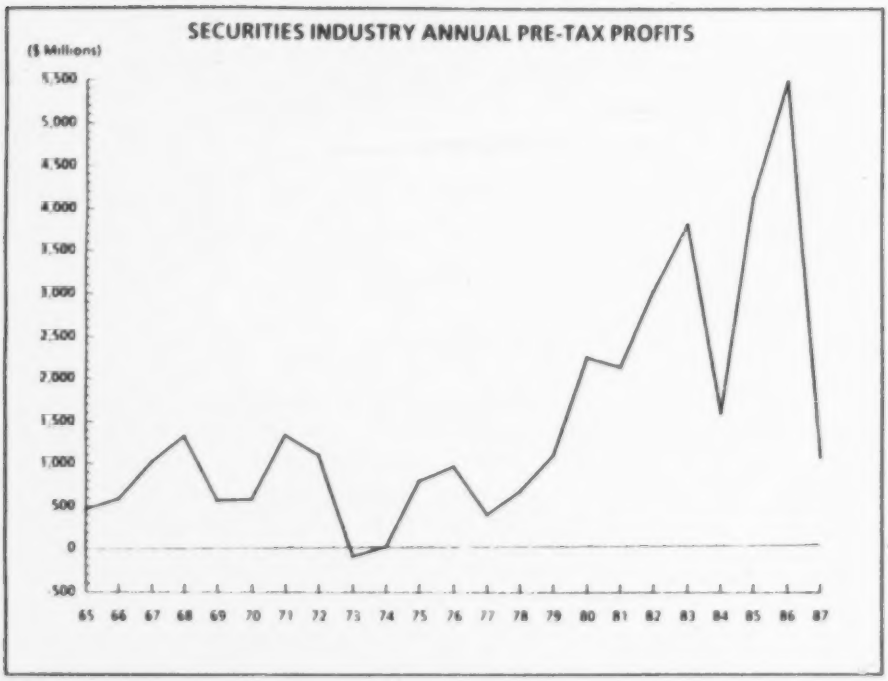
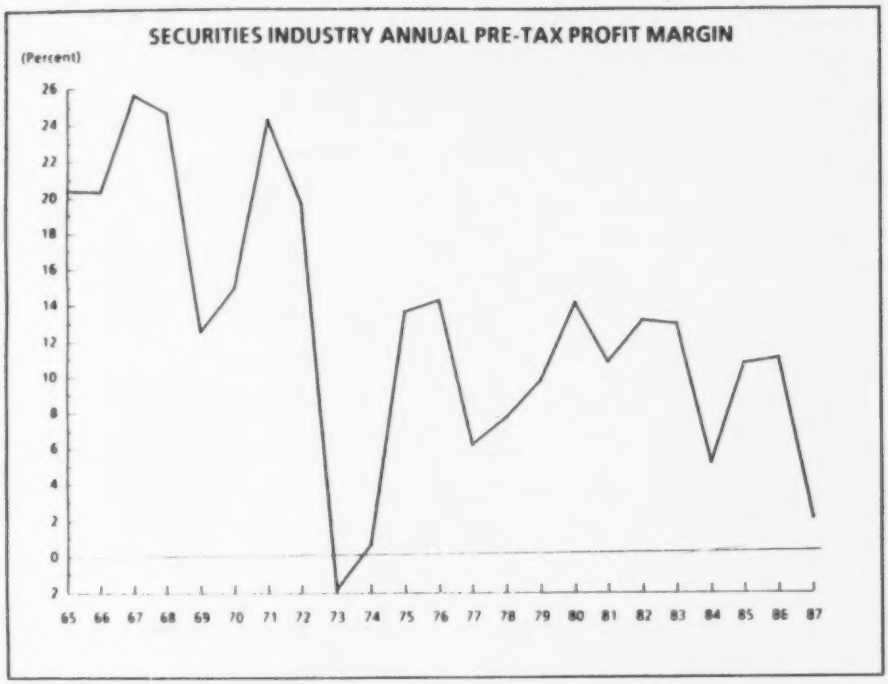


Table 4



This trend towards reduced profitability is even more dramatic when looked at over a longer interval. Table 4 shows securities industry annual profits since 1965. Initially, despite the volatility and the fact that last year's profits fell back to 1960's levels, it appears that profits for the securities industry are trending upwards. But, since the aggregates are growing so large that they're awesome, it disguises the "real" profitability picture. Table 5 measures these profits against revenues and the resultant declining profit margin over the last 20 years is very alarming.

Table 5



Twenty years is a long time to ponder, especially with last year's record black and red ink barely dry on the industry's P&L sheet. A look at the quarterly income statement is both interesting and enlightening.

COMMISSIONS

Column 1 in Table 6 holds many industry quarterly records - the good kind, record revenues and profits. Commissions of $3.3 billion were the most posted in any quarter, although, $3.0 billion in the second quarter and $3.2 billion in the third and fourth were still very close and exceed every quarter of any other year. The record held in 1986 was $2.8 billion in quarterly commissions and in 1985 it stood at just $2.3 billion. For the year, commission revenues hit a record $12.6 billion, a 21% increase over 1986's then record $10.5 billion (Table 8).

October's market collapse was a collapse in price levels...for transaction volume it was anything but. Record 600 million share days helped generate record commissions. In 1986, volume on the New York Stock Exchange (NYSE)

averaged 141 million shares per day. In 1987, average daily volume shot up to 185 million in the first quarter, slipped to 174 million in Q2, returned to 184 million in Q3 but skyrocketed to 212 million in Q4, thanks to October's record volume which averaged 277 million shares per day!

These commission revenues are basically the last remnant of the securities industry of old. An industry which derived more than half of its revenues from this nice, safe, agency commission business only 15 years ago has diversified to the point where only a fifth to a quarter of revenues now come from this "safe" business.

However, this safe business is extremely volume dependent, and after October's surge, volume spiralled downward and with it, commissions.

MARGIN INTEREST

Another equities-linked revenue source is margin interest. Here, again, October's action doesn't appear to have negatively affected the P&L. As Table 6 shows, margin interest fluctuated between $700 million to slightly over $900 million quarterly last year. This was well above the $700 million to $750 million range in 1986 and 1987's $3.3 billion annual tally was up 14% over 1986's level.

Although interest earned on margin accounts fared well all of last year, including the fourth quarter, there is a flip side to the equation. Interest expense, partly incurred to finance margin lending, ranged from $3.3 billion to $3.8 billion per quarter last year, higher than in any previous year. Also, the substantial risk exposure of this business was driven home in October.

Losses in error and bad debt accounts in the fourth quarter skyrocketed to $720 million, more than 3 1/2 times as large as the previous record amount, $203 million experienced in last year's second quarter. Exactly what proportion came from unsecured customer receivables vs. other sources, such as DKs, is not known but probably accounts for the majority of the increase.

Table 6

TOTAL INDUSTRY QUARTERLY INCOME STATEMENT

(In $ Millions)

Revenues	87:Q1	87:Q2	87:Q3	87:Q4
Commissions	3,312.2	2,984.9	3,164.7	3,180.0
Trading Profits	3,886.5	1,861.5	2,372.8	1,801.0
Investment Gains	770.0	284.5	301.5	(1,328.0)
Underwriting	1,453.5	1,483.9	1,552.4	664.0
Margin Interest	700.0	849.7	919.1	865.0
Mutual Fund Sales	792.0	614.0	442.5	360.0
Fees, Account Supervision	383.2	462.8	454.6	508.0
Research	24.6	6.8	7.0	3.0
Commodities	245.4	420.8	283.1	146.0
Other Securities Related	2,549.0	3,113.4	3,004.1	3,009.0
Other Unrelated	600.1	564.7	872.8	764.0
Total Revenues	14,716.5	12,647.0	13,374.4	9,972.0
Expenses				
RR Compensation	2,576.5	2,303.0	2,358.1	2,093.0
Clerical Compensation	2,528.6	2,294.0	2,360.9	1,894.0
Partner/Officer Comp.	403.0	387.6	314.2	403.0
Other Employee Comp.	152.5	174.2	158.9	150.0
Floor (Commission/Clearing)	514.2	535.1	580.5	558.0
Communications	609.5	631.7	645.2	668.0
Occupancy & Equipment	622.4	661.6	690.8	754.0
Promotional Costs	274.0	293.9	289.0	345.0
Interest Expense	3,311.7	3,526.7	3,827.2	3,608.0
Errors/Bad Debts	126.6	203.1	93.5	720.0
EDP	176.0	181.5	192.6	209.0
Non-Recurring Charges	4.5	5.8	9.3	80.0
Regulatory Fees	78.8	85.2	72.3	92.0
Other	1,289.9	834.5	1,046.0	643.0
Total Expenses	12,668.2	12,117.9	12,638.7	12,217.0
Pre-Tax Net Income	2,048.3	529.1	735.7	(2,245.0)

Table 7

NYSE MARGIN DEBT

($ Billions Outstanding, End of Month)

December '86	36.8	July	40.3
January '87	35.0	August	41.6
February	35.7	September	44.2
March	38.1	October	38.3
April	39.8	November	34.2
May	38.9	December	32.0
June	38.4	January '88	31.3
		February	32.0

Also, the trend in margin interest revenues is less than encouraging so far for 1988. Last year began with NYSE margin debt outstanding of $37 billion, by January's close it had fallen to $35 billion but gradually increased month by month to a record $44 billion outstanding as October opened. By October's close, however, the amount dropped to $38 billion, then $34 billion in November, $32 billion in December and fell again to $31 billion in January - the lowest level since April, 1986! However, February's amount increased slightly to $32 billion.

ASSET MANAGEMENT FEES

Another business area which securities firms are pinning some profitability hopes on in light of the market collapse is asset management. This area is viewed as generally bear-proof (although not for the portfolio itself) since it generates a stream of fee income in both bull and bear cycles. In fact, a record fee income of just over half a billion dollars was posted in last year's fourth quarter. Also, the second and third quarter's revenues of $450 million to $460 million each from this source trailed only the fourth quarter of 1987's $508 million and fourth quarter 1986's $506 million. This year has also witnessed a rash of offerings of income funds with above-average annual management fees which should also bolster this revenue source for 1988.

Furthermore, these figures understate the industry's revenue stream from asset management since the data is gleaned from FOCUS reporting of the broker-dealer entity only, and much asset management business is conducted outside of the holding company's broker-dealer subsidiaries.

Table 8

TOTAL INDUSTRY ANNUAL INCOME STATEMENT

(In $ Millions)

Revenues	1986	1987	% Change
Commissions	10,472.6	12,641.8	20.7
Trading Profits	12,560.8	9,921.8	(21.0)
Investment Gains	1,143.3	28.0	(97.6)
Underwriting	5,938.6	5,153.8	(13.2)
Margin Interest	2,919.5	3,333.8	14.2
Mutual Fund Sales	2,801.1	2,208.5	(21.2)
Fees, Account Supervision	1,466.7	1,808.6	23.3
Research	45.6	41.4	(9.2)
Commodities	1,064.7	1,095.3	2.9
Other Securities Related	9,552.0	11,675.5	22.2
Other Unrelated	2,119.0	2,801.6	32.2
Total Revenues	50,082.4	50,709.9	1.3
Expenses			
RR Compensation	9,183.8	9,330.6	1.6
Clerical Compensation	8,423.2	9,077.5	7.8
Partner/Officer Comp.	1,358.0	1,507.8	11.0
Other Employee Comp.	439.7	635.6	44.6
Floor (Commission/Clearing)	1,697.8	2,187.8	28.9
Communications	2,288.1	2,554.4	11.6
Occupancy & Equipment	2,178.5	2,728.8	25.3
Promotional Costs	1,036.4	1,201.9	16.0
Interest Expense	12,425.4	14,273.6	14.9
Errors/Bad Debts	431.9	1,143.2	164.7
EDP	632.2	759.1	20.1
Non-Recurring Charges	70.7	99.6	40.9
Regulatory Fees	310.1	328.3	5.9
Other	4,096.2	3,813.4	(6.9)
Total Expenses	44,570.9	49,641.8	11.4
Pre-Tax Net Income	5,511.5	1,068.1	(80.6)

INVESTMENT "GAINS"

Three-fifths of the $2 1/4 billion fourth quarter loss is directly attributable to securities identified as held for firm investments. The $1.3 billion loss in this column was nearly seven-fold as bad as the $200 million record quarterly loss on investments (Q4, 1986) and nearly double the magnitude of the record quarterly gain for investments ($770 million, Q1, 1987). Combining this $1.3 billion loss with the fourth quarter's record error/bad debt expense ($720 million), accounts for over 90% of the $2.2 billion loss during the fourth quarter alone.

The fourth quarter's losses for firms' investments can almost be forgiven, given the unprecedented markets during this period. However, since securities firms should be astute investors, over a longer time frame, particularly in bull markets, their quarterly performance should be biased upwards. Table 9 does not show this, however. Measuring quarterly percent swings in investment gains (losses) over the past five years, shows this revenue source declining just over half the time (11 out of 20 times).

Table 9

QUARTERLY PERCENT CHANGE IN INVESTMENT GAINS (LOSSES)

1983: Q1	-33	1985: Q3	-36
Q2	+ 19	Q4	+ 195
Q3	-84	1986: Q1	+ 40
Q4	+ 424	Q2	-4
1984: Q1	+ 11	Q3	-70
Q2	-101	Q4	-215
Q3	+ 10,667	1987: Q1	+ 484
Q4	-49	Q2	-63
1985: Q1	+ 80	Q3	+ 6
Q2	-22	Q4	-540

Table 9 also shows how cyclical and volatile firm investment gains/losses are, and this is the P&L line which reflects securities firms' new found love for taking principal positions in their merchant banking deals. Last quarter's $1.3 billion loss in this area effectively wiped out the previous three quarters' gains. Even on an annual basis, firms' performance over the past five bull-market years show mixed results (Table 10).

Table 10

ANNUAL PERCENT CHANGE IN INVESTMENT GAINS

1983	+ 22
1984	-3
1985	+ 53
1986	+ 5
1987	-98